No. 48893-1-II

DIVISION II, COURT OF APPEALS
OF THE STATE OF WASHINGTON

HEARTLAND EMPLOYMENT SERVICES, LLC,

Appellant

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent

ON APPEAL FROM THURSTON COUNTY SUPERIOR COURT
(The Honorable Gary R. Tabor)

REPLY BRIEF OF APPELLANT

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I. INTRODUCTION

RCW 82.04.540 contains only two requirements: (1) a written contract that allocates employer rights and obligations between a PEO and its clients in a coemployment relationship, and (2) written notice to employees. As Heartland explained in its opening brief, the undisputed record shows that both requirements are satisfied here. DOR asks this Court to ignore the plain meaning of RCW 82.04.540, the plain language of the written contract, and the plain language of the written notices provided to employees. In disregarding this plain language, DOR attempts to impose additional requirements not set forth in the statute. This Court should refuse to do so. The judgment below should be reversed, and the trial court ordered to enter judgment in favor of Heartland.

A. The Parties' Written Agreement Allocates Employer Rights and Obligations in a Coemployment Relationship.

DOR acknowledges that RCW 82.04.540 requires a "written contract" between a PEO and its clients that contains an "allocation of employer rights and obligations" among the parties in a "coemployment relationship," DOR Br. at 15, which DOR later notes is "an ongoing relationship rather than a temporary or project specific one." *Id.* at 30 (quoting RCW 82.04.540(3)(e)). The parties' written agreement contains such an allocation and, contrary to DOR's erroneous assertion, the agreement's reservation of "ultimate" control in certain matters to Heartland

does not render the agreement's allocations of employer rights and obligations among the parties meaningless. In any event, the statute does not require or prohibit any particular allocation—only that the written agreement contain allocations of employer rights and obligations. The plain language of the written agreement expressly allocates various employer rights and obligations among the parties, satisfying the statute's requirement.

1. The Agreement's Plain Language Contains An Express Allocation of Rights and Obligations.

DOR asserts that the Agreement lacks any allocation of employer rights and obligations whatsoever, based on the false contention that the Agreement "allocates ***all*** employer rights and obligations to Heartland." DOR Br. at 1, 18 (emphasis added); *id.* at 17 (Agreement "expressly grants all employer rights and obligations to Heartland"). This is simply not true.

In order to make its argument, DOR selectively isolates various responsibilities allocated to Heartland or for which Heartland has final say, arguing that, "[t]aken together" and "as a whole," they should be implicitly construed as if the Agreement allocates no employer rights or obligations to the Clients. *Id.* at 18-19. DOR's argument is directly contrary to the plain language of the Agreement and fundamental principles of contract interpretation. The Agreement unequivocally allocates rights and responsibilities to ***both*** Heartland and its Clients, and it does so well beyond

the "nominal" threshold DOR espouses. *Id.* at 16 (citing ETA 3192.2014). As Heartland argued in its opening brief, and as the Agreement plainly shows, the Agreement expressly allocates various responsibilities and obligations to the Client—some exclusively, and some shared.[1]

Specifically, the Agreement allocates the following employer rights, duties, and obligations to the Clients: (i) determining personnel needs at each Client facility; (ii) creating and amending employee policies at the Client's "sole discretion"; (iii) providing input in "recruiting, hiring, evaluating, replacing, and supervising" employees; and (iv) paying the costs of the wage and compensation expense of each facility's employees as they are incurred. CP 396-97. The Agreement also allocates the following employer rights, duties, and obligations (among others) to Heartland: (i) paying "all federal and state employment taxes"; (ii) providing workers' compensation insurance; (iii) serving as the "rated employer" of record for unemployment compensation purposes and (iv) abiding by the Clients' employee policies. *Id.*

DOR ignores the Agreement's express allocation of employer rights and obligations to the Clients on the ground that the Clients and Heartland

[1] DOR disingenuously suggests that "according to Heartland, an agreement would meet RCW 82.04.540's allocation requirement ... so long as the agreement clearly expressed lack of allocation." DOR Br. at 16, n. 4. Nonsense. Heartland claims no such thing. What Heartland did argue, as explained below, is that the statute does not require that an agreement allocate any particular responsibility to any particular party or dictate the degree to which any particular right or obligation can be allocated between the parties.

share responsibility over hiring and certain other personnel decisions. DOR claims that the Agreement's express allocation of duties is illusory because the Agreement reserves to Heartland with a right of "ultimate direction and control" on some matters or requires the Client to "cooperate with" Heartland, over such matters. DOR Br. at 19, 20 (citing Section 1.03). But DOR's dismissal of the express allocation of employer rights and obligations to the Clients violates fundamental principles of contract interpretation. "An interpretation of a contract that gives effect to all provisions is favored over an interpretation that renders a provision ineffective, and a court should not disregard language that the parties have used." *Snohomish County Pub. Transp. Benefit Area Corp. v. FirstGroup Am., Inc.*, 173 Wn.2d 829, 840, 271 P.3d 850 (2012). Courts "will not give effect to interpretations that would render contract obligations illusory." *Taylor v. Shigaki*, 84 Wn. App. 723, 730, 930 P.2d 340 (1997).

The fact that the Agreement calls for shared—rather than exclusive—responsibility for some matters does not offend RCW 82.04.540's allocation requirement. Nothing in the statute requires employer rights and duties to be allocated exclusively to one co-employer or the other. Undefined terms must be given their "plain, ordinary, and popular meaning," often through "reference to standard English dictionaries." *Wm. Dickson Co. v. Pierce Cty.*, 128 Wn. App. 488, 493, 116 P.3d 409 (2005). The plain meaning of "allocate" is to "apportion," "give," or "distribute ... according to some

predetermined ratio or agreed measure." Webster Third Int'l Dictionary (1981). The term does not preclude an allocation that requires "input" or "cooperat[ion]" between the parties, or one that gives one party final say over some matters. Only if an agreement assigns all rights and obligations exclusively to one party would the allocation requirement go unsatisfied. That is not the case here.

Indeed, it is common and expected that a PEO arrangement will allocate responsibilities such that one coemployer retains final authority over certain matters. For instance, the National Association of Professional Employer Organizations (NAPEO) notes that a PEO contract "may reserve a right of direction and control of the employees" to the PEO. http://www.napeo.org/what-is-a-peo/about-the-peo-industry/what-is-co-employment (last visited 12/28/16). Further, had the Legislature intended RCW 82.04.540 to require a specific allocation of employer responsibilities, or (as DOR espouses) an exclusive one, "it could have said so." *Agrilink Foods, Inc. v. Dep't of Revenue*, 153 Wn.2d 392, 399, 103 P.3d 1226 (2005). But it did not. The Legislature certainly knows how to require the inclusion of specific contractual terms in mandatory terms, including in excise tax statutes. *See, e.g.*, RCW 82.80.100 ("The contract must contain provisions that fully recover the costs to the department of licensing for collection and administration of the fee"); RCW 18.28.100 ("Every contract between a debt adjuster and a debtor shall: (1) List every debt to be handled with the

creditor's name"); RCW 39.04.370(1) ("contract must contain a provision requiring the submission of certain information about off-site, prefabricated, nonstandard, project specific items produced under the terms of the contract and produced outside Washington"). This Court should reject DOR's efforts to add unexpressed, substantive qualifications to RCW 82.04.540. *See Lone Star Industries, Inc. v. Dep't of Revenue*, 97 Wn.2d 630, 634-36 (1982) (invalidating DOR's addition of a "primary purpose test" to tax statute because such an interpretation "exceeds the bounds" of the statute).

DOR also asserts in passing that the Agreement does not involve a "coemployment relationship" in the first place on the unstated theory that the Agreement's use of the terms "from time to time" and "on a daily basis" should be construed to imply that the Agreement does not involve an "ongoing relationship." DOR Br. at 30-31. Yet the Agreement merely reflects the obvious—that the Clients' needs may change "from time to time," and the employees work at the Clients' facilities "on a daily basis" by showing up to work every day. CP 37, 622. As reflected in the ten-year term of the Agreement, the Agreement is intended to involve an ongoing relationship; the two phrases DOR emphasizes in isolation and out of context do not negate the ongoing nature of the relationship.

If the Agreement involved temporary staffing rather than coemployment of long-term employees, it would be explicitly outside the scope of RCW 82.04.540 by operation of RCW 82.04.540(3)(f)(iii).

Tellingly, DOR does not attempt to (and could not) argue that the Agreement provides for temporary staffing. As the undisputed record reflects, employees are recruited and hired by the Client into specific ongoing positions and reevaluated after 90 days, 15 months, and then annually thereafter; employees are not reassigned or relocated. CP 437-39. Thus, Heartland and the Clients clearly intend to establish an ongoing coemployment relationship with all employees.

Finally, DOR repeatedly emphasizes the Agreement's title of "Employee Leasing Agreement" and focuses on the Agreement's reference to Heartland as a "provider of personnel," apparently seeking to create the impression that the use of those terms somehow disqualifies Heartland as a PEO under RCW 82.04.540. DOR Br. at 30. But it is undisputed that the term "employee leasing" is synonymous with providing professional employer services as a PEO. CP 241.[2] Moreover, again, RCW 82.04.540 does not set forth any specific language that a PEO agreement must contain. The Agreement allocates employer rights and obligations as required under RCW 82.04.540.

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[2] See also https://www.entrepreneur.com/encyclopedia/leased-employees ("Employee leasing is a contractual arrangement in which the leasing company, also known as a professional employer organization (PEO), is the official employer. Employment responsibilities are typically shared between the leasing company and the business owner") (last visited 12/29/2016).

2. Extrinsic Evidence Confirms the Plain Language of the Agreement, Which Expressly Allocates Employer Rights and Obligations to both Coemployers.

DOR posits a red herring when it suggests that Heartland is forced to rely on extrinsic evidence to satisfy RCW 82.04.540. DOR Br. at 22-29. For all the reasons set forth above and in Heartland's opening brief, the plain language of the Agreement alone satisfies the statute. Extrinsic evidence merely confirms what the Agreement saysthat the Agreement allocates employer rights and obligations between coemployers with respect to the long-term employment of employees who work at each Client's facility. CP 253-54, 289-91, 324, 413, 419-22, 427-31, 439-55. In short, extrinsic evidence confirms that the Agreement's express allocation is not illusory or a sham.

DOR's argument here primarily relies on the statute's requirement that the parties agreement must be "in writing." DOR. Br. at 23. But there is a writing here—the Agreement. The issue is whether that writing satisfies the statute's substantive requirement, *i.e.*, that there be an "allocation" of responsibilities. And that issue turns on the meaning of the Agreement's terms. Although it is not necessary given the Agreement's plain language, this Court is entitled to consider extrinsic evidence to discern the meaning of those terms. *Berg v. Hudesman*, 115 Wn.2d 657, 668, 801 P.2d 222 (1990) (extrinsic evidence of course of dealing admissible under context rule).

There is no merit to DOR's argument that the parties' course of dealing somehow shows an intention "independent of" the Agreement, or a meaning that would "vary, contradict or modify" its written words. DOR Br. at 26 (citing *Hearst Commc'ns, Inc. v. Seattle Times Co.*, 154 Wn.2d 493, 503, 115 P.3d 252 (2005)). The parties' dealings simply confirm that the Agreement's express allocation is real, and that its reservation to Heartland of "direction and control" in no way divests the Clients' rights and obligations over personnel decisions and employment policies. CP 253-54, 289-91, 324, 413, 419-22, 427-31, 439-55.

Nor is there any merit to DOR's unsupported contention that consideration of extrinsic evidence is contrary to what the Legislature "likely intended" when enacting RCW 82.04.540's "writing" requirement. DOR Br. at 23. DOR cites no authority to support its theory—because there is none. Indeed, for at least a decade prior to the enactment of RCW 82.04.540, DOR allowed companies like Heartland to deduct payroll and benefits costs they incurred providing employer-of-record services to their affiliates. *See, e.g.*, Det. No. 90-371, 10 WTD 155 (1990) ("payrolling agents may exclude employee salaries and benefits paid to them by their client businesses and passed through to the workers"); Det. No. 86-234, 1 WTD 103 (1986) ("if the affiliate is the employer and the taxpayer's sole function is to act as a paymaster, then the taxpayer is merely a conduit for payment of the affiliate's own payroll expenses and amounts received for that purpose are

nontaxable"). Nothing in RCW 82.04.540's legislative history suggests the Legislature intended to alter this tax historic treatment when it enacted the statute in 2006.

Lastly, this Court can reject DOR's suggestion that Heartland's lack of registration as a PEO with the Employment Security Department ("ESD") is some sort of extrinsic evidence in its favor. DOR Br. at 27-29. DOR does not—and cannot—argue that RCW 82.04.540 imposes any requirements regarding ESD registration. It doesn't. Further, DOR ignores the fact that Heartland registered with ESD in 2001—five years ***prior*** to the enactment of RCW 82.04.540—at which time "PEOs were not defined in state laws regulating unemployment insurance." CP 168. When Heartland registered with ESD, the common industry practice was for PEOs to report the wages for clients "under the PEO account." *Id.* While Heartland may not have updated its wage reporting practices when the registration statute was revised in 2007, any impact on its insurance premiums is independent of and irrelevant to the application of RCW 82.04.540.[3] Moreover, DOR submitted

[3] As Heartland explained below, its registration status with ESD likely had no financial impact on Heartland or its Clients. The only potential impact would be on the rates that Heartland must pay for its unemployment insurance premiums, which rate depends on whether one of its Clients has an experience with unemployment claims that is so much better or worse than the group average that it would affect the premium rate. CP 168. Because all of Heartland's Clients operate substantially similar businesses, the rates likely do not vary from Client to Client. This means that there would likely be no impact whatsoever on total unemployment insurance premiums for the group, even if Heartland changed its ESD registration.

no evidence—and there is none—that ESD ever objected to Heartland's reporting practices.

In sum, the plain language of the Agreement satisfies the requirements of RCW 82.04.540 for a written agreement that contains an allocation of employer rights and obligations among a PEO and its clients for employees in a coemployment relationship. The undisputed facts in the record about the parties course of dealing under the Agreement unequivocally supports this conclusion.

B. Employees Receive Many Forms of Written Notice Regarding Heartland's Role as Coemployer.

RCW 82.04.540 also requires that employees "receive[] written notice of coemployment with the professional employer organization," *i.e.*, Heartland. RCW 82.04.540(3)(d)(i). DOR claims that the various forms of notice received by employees here do not "meet the standard of notice that RCW 82.04.540 requires." DOR Br. at 33. But even DOR concedes that RCW 82.04.540 contains ***no standard*** of notice that employees must receive. CP 476 ("the statute does not explain what constitutes 'written notice of coemployment'"). Indeed, DOR's own Excise Tax Advisory ("ETA") 3192 confirms that "no specific language is required," and that the notice only needs to "put the individual employee on notice, either actual or constructive, that the employee is co-employed by both the PEO and the client." CP 282.

As Heartland explained and the evidence shows, the written notice received by employees is more than adequate. *First*, employees receive notice in their employee handbook that, "[m]ost employees are employed by Heartland Employment Services, LLC an employment company of HCR ManorCare." CP 123. DOR argues that this statement is insufficient because employees "may" question whether it applies to them and "how to identify their employer." DOR Br. at 33. But there is no evidence of confusion. Just as important, DOR's argument ignores the undisputed context of the notice: Employees are acutely aware that they are employed by a specific Client from the outset; the Client interviews them and sends them an employment offer letter; and then the Client hires trains, and supervises them. CP 287, 414-33, 436-49. When the employee handbook alerts the employees that Heartland serves as "employment company" for the Client, the employees plainly have notice of "coemployment," which is all that RCW 82.04.540 requires.

Second, employee paystubs list the Client's *and* Heartland's name, along with the HCR ManorCare business name under which both operate. CP 149-50. DOR claims that this too is not enough, DOR Br. at 34, but its own ETA 3192 says otherwise: It is "sufficient notice" if the "PEO is listed in the employee handbook as a PEO (or is adequately described as operating like a PEO) and the employee's paystubs contain PEO's name." CP 283 (quoting ETA 3192). For all the reasons set forth above, DOR's suggestion

that the handbook does not "adequately describe[]" Heartland "as operating like a PEO" defies reality. DOR Br. at 35-36. Employees already know the Client is their day-to-day functional employer; the handbook and paystubs let them know that Heartland acts as a co-employer of record. Indeed, why list both the Client and Heartland on the paystub other than to give employees notice of a coemployment relationship?

Third, employees sign a "Letter of Understanding" in which they recognize that they are "employees of" the Client and that Heartland is the "employment company." CP 388. DOR asserts that this is "not notice ... of a coemployment relationship" because the letter also references "HCR ManorCare." DOR Br. at 37. Yet DOR fails to explain how this notice fails to alert employees of Heartland's involvement as co-employer—particularly since it specifically states that Heartland is an "employment company," *i.e.*, a professional employer organization. CP 388. Further, as DOR has acknowledged, it is widely known that HCR ManorCare is "used to reference HCR Healthcare, Heartland, and all of the other affiliated companies," including the Clients. CP 260. Here, again, there is no evidence of confusion and ample evidence of actual or at least constructive notice of coemployment.

Fourth and finally, employees receive written notice that Heartland is a "Temporary Services Agency; Employee Leasing Company; or Professional Employer Organization"—in other words, a PEO. CP 393.

DOR asserts that this is insufficient because it lists "three different types of entities that Heartland could possibly be" and names "HCR ManorCare, LLC" as a workers' compensation insurance carrier. CP 394. But, again, there is no evidence of employee confusion, and DOR's assertion ignores the undisputed fact that "Employee Leasing Company" and "Professional Employer Organization" are synonymous. CP 41. Thus, even if the statute required notice of coemployment specifically by a "PEO" referenced as such, which it does not, employees receive notice that uses that term by name or acknowledged equivalent. Hence, this notice that Heartland is a PEO provides more than enough actual or constructive notice of "coemployment with the professional employer organization"—particularly when combined with the other three forms of written notice of Heartland's role that employees also receive.

VI. CONCLUSION

Since its formation in 2001, Heartland has provided professional employment services as the employer of record for its various HCR ManorCare Clients. Heartland provides its services pursuant to a written agreement that allocates employer rights and obligations between Heartland and its Clients in a coemployment relationship. Employees also receive various forms of written notice regarding Heartland's role. As a result, Heartland easily satisfies the two requirements of RCW 82.04.540, and

Heartland's payroll and benefits costs paid to employees are not subject to B&O tax.

RESPECTFULLY SUBMITTED this 30th day of December, 2016.

LANE POWELL PC

By _____
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CERTIFICATE OF SERVICE

I hereby declare under the penalty of perjury of the laws of the State of Washington that on December 30, 2016, I caused to be served a copy of the foregoing document to be delivered in the manner indicated below to the following person(s) at the following address(es):

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